1 Political Economy in the Study of Public Policy

Public policy in a liberal democracy arises as the outcome of competition among political parties for support from a diverse electorate. This process plays a significant role in determining how economic resources are used in both the public and private sectors. In our view, a full understanding of either part of the polity must therefore consider the relationship between political competition and resource use, whether our purpose is to understand actual policy choices, to judge the resulting outcomes from some normative perspective, or to formulate alternatives. Acknowledging political competition as a primary driver of public policy also leads to the study of how political institutions work, and to assessments of how well they work, instead of, or at least in addition to, the study of the setting and consequences of specific policy instruments. An emphasis on institutions follows, for the same reason that acceptance of the market as an allocation mechanism leads the analyst of the public interest to study property rights and market regulation rather than the reasons for particular prices and quantities.

Our purpose in this Element is to outline the components of such a political economy approach to the analysis of public policy while contributing to its development by studying the meaning of political competition and the role it plays.[1] For part of the analysis, we take the degree of competitiveness as given to consider how working within a framework in which policy choices must always pass a political test affects the nature of policy analysis. We also discuss the measurement and implications of changes in its intensity.

A general sense of our approach to the study of public policy can be gained by briefly comparing it to three well-known alternatives.[2] The exchange-contractarian approach is also concerned with the political economy dimensions of public policy, but from a contract-constitutional perspective.[3] While political economy as we conceive of it stresses the study of how electoral competition shapes fiscal systems and other policy instruments, and how specific aspects of the political process can lead to both desirable and undesirable uses of economic resources, this approach focuses on the need for and design of controls that limit the discretionary power of politicians and public administrators from a classical liberal perspective. Controls at the procedural level as well as restrictions on the

1 Background to our analysis is provided by texts and handbooks that combine political economy and public economics. See, for example, Persson and Tabellini (2000), Drazen (2000), Mueller (2003), Cullis and Jones (2009), Hillman (2019), and Congleton, Grofman, and Voigt (2019), among others.
2 Hamlin (2018) provides an extended comparison.
3 This tradition originates with Wicksell (1896). The contemporary literature begins with Buchanan and Tullock (1962).

setting of various policy instruments are considered. Work in this tradition is also motivated by a desire to minimize the coercion that must occur when a citizen agrees to be part of a collective enterprise.[4]

In contrast to the political economy and exchange-contractarian approaches, there is no formal role for politics in existing normative approaches to public finance and public economics. In the public finance tradition, emphasis is placed on various criteria for the design of fiscal systems.[5] These include the minimization of the excess burden of taxation that is part of the full cost of public services, the achievement of horizontal and vertical equity among taxpayers, and the principles of good tax administration. The main focus is on the design of policies that strike a reasonable compromise among these sometimes conflicting criteria.

The public finance tradition has been supplanted by the optimal tax or social planning approach, in which the analyst is guided by the results of optimizing a utilitarian social welfare function with respect to a set of exogenously determined policy alternatives, subject to constraints that are understood to be strictly technological – that is, nonpolitical – in nature, including the costliness of identifying the characteristics of taxpayers, the equilibrium structure of the private economy given individual preferences, technology and endowments, and the government budget constraint. Planning of this kind is an attempt to establish an ideal policy structure that can be used to judge the appropriateness of existing policies and as an aid to the design of better ones.[6]

Both public finance and social planning advocate specific fiscal and other policy structures without acknowledging the role of democratic choice. Indeed, for many practitioners of these approaches, it seems fair to say that competitive politics is regarded as something that often gets in the way of better resource allocation and that must, from time to time, be overcome to achieve better policy outcomes. As Scott (1987, 219) put it: “Economists and public finance specialists pay tribute to the idea of competition in the private sector. But competition in the public sector often makes them uneasy.”

We view the willingness to plan substantial parts of the public sector as inherently problematic in a democracy. At the same time, we acknowledge that

[4] Martinez-Vazquez and Winer (2014, chapter 1) review the literature on coercion and collective choice.

[5] The public finance classic is Musgrave’s *Theory of Public Finance* (1959). The Canadian Royal Commission on Taxation (1966) is a tax reform in this tradition. There are no tax commissions based on either the political economy or exchange-contractarian traditions.

[6] *Lectures in Public Economics* by Atkinson and Stiglitz (1980) is a seminal text in the optimal tax tradition. See Salanié (2011) and Boadway (2012) for recent expositions. The Mirrlees Review (2011) is a commission based on this perspective. Boadway and Hettich debate the merits of a social planning versus a political economy approach in Winer and Shibata (2002).

while established normative public economics is often at odds with the forces of electoral competition, this does not mean that the political economy approach we explore in this Element is complete or unassailable. Indeed, in its current state, this approach lacks a widely accepted analysis of the normative properties of electoral equilibria paralleling the first theorem of welfare economics that underlies the design of public intervention in private markets.

1.1 A Brief Outline

We begin in Section 2 by discussing the centrality of competition to the study of both economics and politics. Several distinct but related ideas about the nature of political competition are presented, followed by a comparison of the elements underlying the study of economics with their counterparts in the study of politics.

The stage is then set for an evaluation of the consequences of electoral competition for the allocation of resources. We follow the three steps used in neoclassical welfare economics, beginning in Section 3 with the choice of a standard of reference appropriate for judging the efficiency of an electoral outcome. Next, we use a probabilistic voting model to develop a ‘first theorem’ that identifies conditions under which the equilibrium of a perfectly competitive and well functioning polity is efficient. As a complement to this analysis, we consider the implications of ignoring the fact that policy choices are part of the electoral equilibrium including difficulties that arise with identification of the redistributive effects of policy, with second-best analysis, and when the political feasibility of a proposal is not taken into account. Further discussion in an Appendix elaborates on the modelling of voter behavior, considers why an electoral equilibrium may break down because of the underlying instability of majority rule, and illustrates how determinants of electoral competitiveness can be studied.

The third step in the analogue to welfare analysis is taken in Section 4, where we use our comparison of economic and political behavior to guide the identification and discussion of significant problems that may arise with the allocations that competitive elections produce. Our discussion emphasizes the ways in which electoral competition exacerbates and attenuates these problems.

In Section 5, the evolution of tax systems, consisting of bases, rate structures, and special provisions, is explained as the outcome of sorting on economic and political margins in the face of transaction costs. The meaning of tax reform in this context is considered, and some ideas about good tax structure arising from the exchange-contractarian, social planning, and political economy approaches are compared in the light of the understanding of tax systems that we present.

In Section 6, we move from an analysis with a fixed degree of competition to one in which competitiveness is imperfect and variable. We outline various measures of competitiveness that have been proposed, illustrate the variation in competitiveness that arises in mature democracies, and sample some of the work that has explored the implications of this variation for the structure of the public finances and for economic activity. Section 7 offers a brief conclusion.

1.2 Limiting the Scope of Our Inquiry

Our analysis deals with the theory and practice of governance in liberal democracies. The use of the adjective "liberal" acknowledges the written laws and unwritten conventions that limit the extent to which any citizen may be forced to accept the consequences of government actions. These constraints on governing power significantly shape the political process, which in a liberal democracy exhibits the following characteristics: (1) each election outcome is ex ante unpredictable in the sense that everyone knows what is possible, but never what will actually occur; (2) the ex post outcome of any election is irreversible; and (3) the contest will be repeated into the foreseeable future (Przeworski 1991, chapter 1). Sartori (1976) and Bartolini (1999) see the institutions that fulfill these conditions as providing the rules of the game, and political competition as the process through which these institutions function more or less effectively.

While the authority of the state in a liberal democracy is constrained, it still encompasses a monopoly on compulsory taxation that allows a substantial reduction in the cost of transferring resources from private to public use.[7] Acquiescence to this authority goes hand-in-hand with demands from citizens who expect a substantial return on their taxes.

2 Thinking Generally about Economic and Political Competition

Although competition is an essential part of economic science, its purpose is often misconstrued in everyday conversation. There is a popular misperception that competition in a market is akin to a zero-sum game for control of resources when it is, instead, a description of how markets induce workers and owners of capital to cooperate with each other and with consumers to earn income while satisfying wants (Rubin 2019). The basic unit of analysis in economics is a voluntary transaction between two agents; competition selects the best cooperators, and the economics of a market economy is a study of cooperative

[7] A general monopoly on the legitimate use of force is the centerpiece of Weber's (1946, 78) definition of the state.

capitalism (Rubin's term) in which many firms and the consumers they serve can all be successful at the same time.

In contrast, politics is about conflict over control of government and the resources it commands in a situation in which only one party or coalition can be successful at any given moment. In a society where constraints on the power of the state have matured, political competition, like economic competition, may have a socially productive role – an issue we shall explore. Still, the win/lose character of election outcomes, in contrast to the sharing of the same market by different firms, imparts a zero-sum character to political rivalry that competition in markets does not have.

There is another, deeper reason why competition in politics is more about conflict than is competition in the economy. Rubin (2002, 2014) points out that from an evolutionary perspective, conflict among individuals and groups over access to resources – that is to say, politics – was more important in the development of the human brain and social behavior than was economic scarcity. This is because nature is not a strategic player, so that conflict among individuals and groups, who do act strategically, was a more potent force driving the evolution of the brain than was the struggle against nature. Thus, today we find that "when faced with an interpersonal issue that does not involve family or sex, an individual untrained in economics is more likely to treat it as a political issue than as an economic issue" (Rubin 2014, 912). Perhaps it is the study of politics rather than economics that deserves to be called the dismal science.

2.1 Approaches to the Nature of Political Competition: Objectives, Process, and Location

If we want to go beyond the general idea that political competition is the process through which democracy functions, how should we think about it? Several useful approaches have been developed, each of which points to a particular dimension of the same encompassing process:

(1) *The struggle for governing power*. This perspective defines political competition as a contest among political parties for the right to govern (e.g., Schumpeter 1950; Strom 1990; Wallerstein 2004; and others). Following Becker (1958) and Dahl (1989), this process can be said to be fully competitive when the struggle for office is open to challengers and the electorate is broadly based. In this view, elections decide who is to choose public policies. They do not produce policies directly.

(2) *Responsiveness*. A competitive system is one in which parties are responsive to the demands of voters (e.g., Dahl 1971; Issacharoff and Pildes 1998;

Soroka and Wlezien 2010). The emphasis here is not on the prize sought but, rather, on how a party wins. Those who adopt this perspective measure the congruence between public opinion and the ideological platform of political parties, or estimate the responsiveness of public policies to changes in the demands of the electorate.

(3) *Preference formation and discovery*. This approach follows the previous one when we ask: What are parties are responsive to? Wohlgemuth (1995, 84, 2002), following Hayek, argues that "political competition can be reinterpreted to be … a communication process in which preferences and opinions are created, discovered, selected and disseminated." In other words, politics is more than just a means of aggregating known preferences into a social decision. Sen (1999, chapter 6) also highlights the instrumental role of democracy in enhancing the ability of citizens to express their opinions and to support their claims to attention, a view which illustrates the close connection between political competition and ideas about democracy.

(4) *Selection and accountability*. We may also think of political competition as the process through which representatives are hired and fired. (See, e.g., Buchler 2011). Emphasis in this case is on the quality of those who compete in and win election contests. This perspective also deals with the principal–agent problem, studied extensively by Besley (2006) and others, which exists because enforcing good behavior by elected officials is costly. Popper (2013, vol. 2, 368) regards the accountability of elected representatives and the ability to replace them without bloodshed as minimal requirements for democracy, illustrating again the connection between competition and democracy.

(5) *Special-interest politics*. In this tradition, political competition is a veil for rivalry among special-interest groups. One branch of this approach, exemplified by the work of Becker (1983, 1985), emphasizes the struggle among groups to obtain favored public policies and the full cost, including excess burden, of the taxes required to pay for them. Another branch focuses on the use of resources by special interests to artificially create and capture rents (e.g., Tullock 1967; Krueger 1974).[8] In both cases, competition among groups need not always be mediated through elections (Medina 2007).

(6) *Location*. Finally, we may describe political competition in terms of its location. Competition takes place (i) in elections among candidates at a local or district level, and (ii) in elections among parties in the jurisdiction as a whole. It also takes place (iii) between elections among parties in the legislature and (iv) among governments at various levels in a federation or among countries.

[8] Hillman and Ursprung (2016) discuss the differences between the two branches.

These views about the nature of competition emphasize either the objectives of political parties or interest groups (1 and 5), the procedural dimensions of the competitive process (2, 3, and 4), or its location in the polity. In much of what follows, we will focus on the implications of interparty rivalry for political office while keeping the other dimensions of competition in mind. The location of competition will be of particular interest when we consider how to measure the competitiveness of elections.

2.2 A Prelude: Contrasting Elements in the Study of Economics and Politics

In Sections 3 and 4, we explore the normative character of competitive political equilibria by following the steps used in neoclassical economics to evaluate market outcomes rather than by using a social planning approach. To facilitate this analysis, it is useful to delineate beforehand the difference between the comparable elements that underlie an economic model of a market and a political economy model of public policy. Doing so will help to identify and organize discussion of the reasons why electoral equilibria are more or less likely to result in socially desirable outcomes.[9] Accordingly, we outline what we see as essential differences arising between the following pairs of basic elements, namely: (1) consumers and voters; (2) firms and political parties; and (3) markets and elections. We invite the reader to write down their own list of essential differences to compare to those we present.

2.2.1 Consumers versus Voters

Voters, like consumers, are rational, consistently fitting means to ends. But when deciding on which party to support they are less instrumental in the sense that voting is not based only on how electoral promises translate into individual economic welfare (Becker and Mulligan 2017). This reduced instrumentality has several origins, including:

(1) *Rational ignorance*: Because an individual vote has little impact on policy choice and information is costly to acquire, individuals do not find it worthwhile to acquire all of the information necessary to assess the consequences of alternative platforms (Downs 1957).[10]

[9] For alternative ways of proceeding, see Ursprung (1991), Glazer and Rothenberg (2001), Besley (2006, chapter 2) and Tanzi (2018).

[10] Similar logic leads to the question of why anyone bothers to vote, though in fact many do – this is the paradox of voting. Blais (2000) provides evidence for one well-used answer: voting is regarded as an act of civic duty.

(2) *Expressive voting*: Since the link between the act of voting and what governments do is weak compared to the connection between market choices and individual welfare, voting has an expressive component that is similar to the enjoyment of the solidarity that comes from cheering for a football team (Brennan and Lomasky 1993).
(3) *Ideological and other nonmarket objectives*: In political life, where it is less costly, people act in part to satisfy their loyalty to an ideology or other nonconsumption-related goals. This is not a matter of a lack of information (Caplan 2007).
(4) *Behavioral biases*: In the electoral setting, voters have a reduced incentive to deal with cognitive biases. While also present in market decision-making, the consequences are more directly costly to individuals there (e.g., Schumpeter 1950, 261–62; Frey and Stutzer 2006).[11]

As a bridge to the next pair of elements, we note that parties are surely more instrumental than are voters because parties can benefit from strategizing in the conduct of their activities.

2.2.2 Firms versus Parties

The textbook private firm continually uses its resources to produce and market goods in order to maximize the profit of its residual claimants – its shareholders. Consequently, the output of a successful firm is always in line with what its customers want and, to achieve that, the firm will follow its customers' tastes closely. In contrast, political parties have no residual claimants who bear most of the consequences of the party's success or failure (Demsetz 1982, 2008). As a result, and unlike firms, a party consists of a coalition of people with differing objectives, some of whom seek to maximize expected votes – a political analogue to profits – while others pursue ideological or policy-oriented goals even at the expense of winning (Wittman 1983; Aldrich 1995; Roemer 2001).

Like firms, parties cultivate a brand or, in political terms, an ideology, in part because this reduces information costs for its "customer base." Branding is also important in politics because it attracts the ideologically committed activists and donors who help with the problems of maintaining a political organization.

Firms and parties also differ in the credibility of their commitments. Compared to a political platform, the smaller dimensionality and greater measurability of a firm's products allows enforcement of broken promises through the courts. In cases where promises are not justiciable, the firm develops

[11] See also Popkin (1994), who studies how voters struggle with their (perceived) decision-making problems.

credibility by investing in a reputation for quality, an asset permitting a price premium that allows its shareholders to be favorably compensated when the firm does not cheat (Klein and Leffler 1981). The unavailability of third-party enforcement for election promises and the lack of a similar compensation mechanism make it more difficult for political parties to establish credibility in their commitment to a proposed platform, though formation of a party coalition will, to some extent, require it to honor the bargains made between coalition members (Levy 2004). An independent press in a liberal democracy may also play a role in maintaining party credibility by exposing false and broken promises, though this too will not work as surely as adjudication of a private-market contract.

2.2.3 Markets versus Elections

A market is a decentralized allocation mechanism in which relative prices channel privately owned resources toward their highest value uses. Underlying this mechanism is the fact that in a market, the transaction value of purchases and sales are closely tied – "you get what you pay for" – and consequently differences in the intensity of individual preferences play a role in shaping the equilibrium allocation. In contrast, an election is a collective choice process in which, absent unanimity, everyone must compromise and there will invariably be a difference between what each person wants for the taxes they pay and what they actually receive.

The matching of costs and benefits is made even less precise by the presence of public goods for which the levying of individual tax-prices that mimic market pricing is impractical, and by redistribution, in which case it is counterproductive, while the role of intensity of preference is further clouded by a franchise that assigns one vote to each person regardless of income and tastes.[12]

Personal agency is constrained in a collective choice process compared to a market because of the need to compromise with others. It is also reduced for a second reason. While consequential market exchange can be carried out alone, altering public policy requires cooperation within a political organization, an activity, like the provision of a public good, which is subject to problems of free riding.

[12] Ledyard (2006, 2014) provides an overview of the literature that deals with the problem of levying taxation according to benefits received. Vickrey (1977, 699) explains why intensity of preference is not formally incorporated in a collective choice process: "[W]hen intensity of preference is introduced … the procedure becomes subject to subversion by the strategic misrepresentation by individuals of their true preferences, and the whole process becomes a competition in deception."